



# Best Practices 2000

## Focus on Multifamily Housing Development & Management

U.S. Department of Housing and Urban Development

March 2000

<http://www.hud.gov/bestpractices.html>

Issue No. 1

While economic growth has helped many, it has also increased rent levels to record highs, leaving low-income families to compete for a dwindling supply of affordable rental housing. Too many families still cannot afford a decent home where their children can be raised safe and healthy, or where senior citizens can grow in modest comfort.

HUD has been proud to make strides in increasing the supply of affordable housing and improving the quality of life for people who live in HUD-insured or HUD-assisted housing.

HUD's Mark-up to Market program was introduced last year to encourage apartment owners to stay in the Section 8 program and keep rents reasonable for low-income renters. Before the introduction of the program, the potential for increased rental income in the private market caused some landlords to "opt-out" of the Section 8 program when their contracts were eligible for renewal. This trend was threatening the best affordable housing, since opt-outs were

**William C. Apgar**  
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more likely to occur in low-poverty neighborhoods where good

housing also brings better opportunity—more jobs, better schools, and less crime.

Now, Mark-up to Market assistance is being offered to owners of well-managed and well maintained properties as an incentive not to abandon the program. The latest data show that opt-outs have dropped by 75 percent since HUD introduced the program. So, by offering the mark-up option we averted a crisis of affordable housing.

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## Housing Mission

The mission of HUD's Office of Housing is building better neighborhoods. What about providing shelter to those that can't afford costs of the private market? Multifamily Housing supports communities by maintaining and expanding residential choices and improving its portfolio. To achieve this, we make the best use of resources and successfully manage risk by working with and through private and public partners.

• **Performance** - We dedicate our efforts to balancing consistently better public service with consistently better value.

• **Portfolio** - We protect and enhance our portfolio nationwide—insurance, notes, property and subsidy.



Jacqueline Jones, Interstate Realty, Marlton, NJ

• **Residents** - We protect the rights of tenants; provide decent, safe and sanitary living conditions; expect them to demonstrate responsible behavior; and solicit their active participation in decision making regarding the properties.

• **People** - We develop, sustain, and support motivated, creative, results-oriented staff.

• **Partnerships** - We build valued relationships with committed and capable partners.

## Model for Multifamily Housing Development and Management

• **Programs** - We are accountable nationwide to deliver flexible products meeting diverse needs, administered in a fiscally responsible manner.

• **Resources** - We work where our specialized expertise and financial resources will make the most difference.

• **Organization** - We are continually refining a streamlined organization that makes good decisions promptly, using the latest technologies and management systems.

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# Successful Multifamily Property Development

## Multifamily Development Principles

**Market analysis.** A market analysis is conducted to determine if the proposed units are in demand. The surrounding neighborhood should also be evaluated. More simply, look at its neighborhood and the properties around it. A property will tend to go the way of its neighborhood.

Is the project competitive? Loss of competitiveness can be devastating to a project as it ages. Be aware of this potential and work with the owners to keep the project appealing and marketable.



Bill Harris - Culpepper Gardens, Arlington, VA

Curb appeal can be critical. Check physical inspection reports for signs of deterioration. When you see occupancy begin to fall, investigate, don't wait. Seek the expertise of an appraiser if necessary.

### Red Flags

**Job loss:** Job loss in an area is eventually reflected in occupancy rates of properties. Be aware of economic and employment trends. During a downturn, there may be ways to minimize the impact on a project through financial management. Seek the expertise of an economist if necessary.

**Functional obsolescence:** Perhaps the unit sizes are small, and were built as temporary housing, or to meet a special market demand. If you have a project in your portfolio that suf-

fers from functional obsolescence, you can look at rehabilitation programs that can result in more suitable reconfigurations, which will result in increased marketability. But make sure that the rehabilitation is economically feasible, that is, the after rehabilitation rents can be obtained in the marketplace. You can seek assistance from a construction cost analyst and an appraiser.

**External obsolescence:** In this case, a neighborhood that was once suitable for housing begins to change. Industrial uses may be introduced or environmental hazards may come into play. Watch for changes in the surrounding area. This may be a project that you would not want to entertain for rehabilitation. Seek advice from an appraiser and the environmental compliance officer.

### Neighborhood Analysis

**Adding value to the neighborhood.** The construction or rehabilitation should be good for the neighborhood. Will the improvement of this property have an impact on the neighborhood or would the impact be negligible? Before a decision is made about what to do with a property, you must look at the community and determine if the steps you plan to take make good business sense.

**The neighborhood should have a positive impact on the project.** Projects may begin to falter because circumstances in the neighborhood begin to change. There may be an increased crime rate, or the residents may begin to see drug-related activities. In such cases you may find that financial solutions simply do not work. The success of a project is certainly dependent on its good physical condition and financial health, but if the neighborhood is declining, the neighborhood needs to become the focus. The property may be able to contribute positively by organizing a neighborhood network program, or creat-

ing an alliance between the tenant association and other neighborhood residents.

**Rents.** Determine market rents. Without rent ceiling restrictions, rent will tend to be close to rent levels in other similar buildings in the neighborhood. Market rents are the amount an owner can rent a unit for based on its location, size, condition amenities and what the market will bear.

During the underwriting of a project determine the rents to be charged, and the expected expenses. The difference between the rent and the expenses gives us NOI or net operating income. The NOI is used to determine the mortgage amount that can be supported by the project.

**Property Characteristics.** Determine the conditions of the property and consider design characteristics. The condition of existing properties and their features will make them more or less attractive on the market. First, the property's physical condition affects the rent that can be charged and the amount that must be spent on maintenance needs.

A property also has design or site features that affect its marketability. A property with an unusual design may have difficulty attracting tenants and may be difficult to turn into a market rate property without substantial rehabilitation costs. A property with lead paint or underground storage tanks will be less attractive to purchasers because of the associated costs.

**Economic Conditions.** The economic conditions in the market area should be stable or improving currently and for the foreseeable future.

**Location.** Based on the tenant population you are trying to serve, choose an appropriate site based on

several factors. Properties in desirable locations tend to have higher rents. People are willing to pay more to live there, so owners can charge more. "Location," refers to all of the neighborhood characteristics that might influence a person's decision to live there: physical attractiveness of the area, access to transportation and employment, access to downtown and other areas of interest, quality of local schools, safety, etc.

**Regulatory approvals.** Determine if the zoning is appropriate for the property and that design and construction are consistent with local and state plans, fire and building codes. Acquire necessary permits.

**Environmental conditions.** Determine any issues related to hazardous waste, air or water pollution, floodplain management, wetland protection, historic trust compliance, noise abatement.

## Sound Underwriting

Proposed projects must provide a fair return to the initial investors/owners. A thorough analysis of the project's pro forma will determine whether income will be sufficient to cover operating costs, including maintenance and upkeep of the property, make monthly mortgage payments and make needed repairs and capital improvements over the life of the loan.

An investor can receive a return based on:

- Appreciation of the real estate
- Cash flow from the rent
- Protection from inflationary pressures
- Tax benefits
- Tax credits
- Depreciation
- Losses to offset other income
- Management fees

**Working with Good Owners.** Owners should be honest, capable,

and have the resources necessary to complete the deal. Good owners have demonstrated their ability to repay obligations and have the technical expertise to develop and/or build the proposed project. In short, the owners should have a proven track record in developing similar projects. Owners should have reasonable capital at their disposal and have the ability to raise additional capital.

**Analysis of Income and expenses.** A simplified version of this approach looks like this:

- Potential Gross Income (rents at 100% occupancy)
- Vacancy and collection losses
- = Effective Gross Income
- Expenses
- = Net Operating Income
- Debt Service
- = Pre-tax cash flow
- Taxes
- + Tax Credits
- = After-tax Cash Flow

**Impact on value.** One way of judging the value of a project is to compare the Net Operating Income to the Market Value. This ratio is referred to as the "capitalization rate" or "cap rate." This is not the same thing as the "yield" to the investor; rather, it expresses the amount an informed purchaser would be likely to pay for the future income and resale of the property.

The cap rate incorporates many factors including the level of risk for a property, and the rate of return on similar investments. All other factors being equal, the riskier project will have a higher cap rate and a lower value. For two similar properties, the

one with the higher Net Operating Income will have a higher value.

For example, if everything else were unchanged, lowering expenses would increase Net Operating Income, and therefore result in a higher value. But in some cases, expenses might appear falsely low due to poor maintenance, or expenses might appear artificially high due to unwarranted salaries to staff. The resulting low apparent value would not then be a true indication of the real value of the property.

**Impact on mortgage underwriting.** Net Operating Income must be sufficient to allow repayment of the mortgage and provide an attractive return to the investors. The ratio of the Net Operating Income to the debt service requirement is called the "debt service coverage" ratio, or DSC. A higher DSC, means that more income is available to pay the loan and provide a profit. HUD typically requires a DSC between 1.11 and 1.18, depending on the mortgage insurance program being used.

"Loan-to-Value" ratio, or LTV is another measure of the credit quality of a loan. This represents the equity



Focus group participants sharing ideas.

position of a mortgagee at the outset of the loan; the lower the number, the smaller the loan and the greater the equity of the borrower in the property. For most underwriting purposes, DCS is the more widely accepted criterion of the credit quality of a loan.

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**Housing Tax credits.** Tax credits are a government supported mechanism for encouraging private investment in affordable housing (and other projects that serve the public good such as historic preservation). Under the Low Income Housing Tax Credit Program (LIHTC), developers of affordable housing are issued tax credits. The developers can then “sell” these credits to investors who use the credits to reduce their tax liability. Develop-



Robert Tourigny, Housing Administrator, Southern Maryland Tri - County Community Action Committee, Inc., Hughesville, MD

ers use the credits to encourage investors to invest their money in the affordable housing project. This mechanism can raise substantial equity to help finance development. The credits are issued with rent and occupancy restrictions which apply to a portion of the units. Rent (including utilities) cannot exceed rent limits designed to be affordable to low income tenants. The income of the tenants in the affordable units is also restricted.

### *Advantages of tax credits*

- Tax credits can raise a large amount of private equity investment to reduce the capital cost of housing development relative to other affordable housing programs.
- The restrictions imposed by the tax credit statutes ensure that the tax credit units will remain affordable over many years.

### *Disadvantages of tax credits*

- Rent and occupancy restrictions limit options for the property.

- Tax credits investors face significant tax liability if the project does not stay in compliance with the rent and occupancy requirements.

- If a “passive” investor becomes involved in the daily management of the project, serious tax liability issues arise. This can complicate negotiations between the Project Manager and the ownership entity regarding projects that require changes in management.

- The rules governing tax credits are complex. Expert legal and financial advice is essential.

## HUD's Role

**Credit enhancement.** Credit enhancements take many forms; for example: letters of credit, cash escrows and HUD mortgage insurance. Credit enhancements reduce the financial risks to the mortgagee. Because HUD insurance is backed by the full faith and credit of the U.S. government, even the riskiest deal can receive an investment grade rating. In turn, this may provide access to the secondary markets - meaning the investment is liquid, or can be bought and sold.

**Community Underwriting.** Unlike some conventional lending, HUD seeks to include in its underwriting decisions factors that (a) enhance the goal of building better neighborhoods, (b) strengthen HUD's security interest in developments for which it provides mortgage insurance, and (c) provide equal opportunity in all HUD funded and/or insured projects. These are some of the ways that HUD mortgage insurance is a “good deal” for the nation as a community.

**Construction, rehabilitation, or repair.** Many HUD loans involve construction of some kind and provide for “insured advances” or requests by mortgage lenders to disburse some of the funds from the mortgage

to pay for ongoing construction. The mortgage is insured by HUD for the amount of funds disbursed even if the mortgagor defaults before construction is completed.

## Financing Property Improvements

**Section 223(a)(7) Refinance Program** - This program provides for the refinancing of an existing insured project. The goal of this program is to reduce the interest rate to improve the economic health of the project and allows the owner to borrow up to the original mortgage amount and term to pay for any necessary repairs.

**Section 223(f) Purchase or Refinance Program** - This program enables owners to obtain HUD mortgage insurance for the purpose of purchasing an existing project or refinancing an existing project. This program permits repairs, but cannot be used for major renovations.

**Rehabilitation** - HUD offers numerous programs that can help in the rehabilitation of a project. Section 221(d)(4) coupled with tax credits can provide a mechanism for facilitating either the development or the rehabilitation of affordable housing. The Section 221(d)(4) can also be used to rehabilitate and to make competitive existing market rate units. Section 241, a supplemental loan, is available to HUD insured projects for up-grading and modernization so that the project remains competitive.

**Mortgage Modifications** - Modifications can be made to existing projects to reduce the interest rate and to improve economic feasibility. This can generate more funds to operate the project.

**Tax Credits and Abatements** - Tax credits can be used to generate new housing or rehabilitate older stock that may be in need of modernization. The sale of tax credits to



investors can generate the capital needed to improve a project and provide an affordable housing resource. Tax abatements can be obtained from local and state authorities to help reduce the operating expenses and to improve project operation. Project managers should explore abatements for projects that may be experiencing financial difficulty.

## Successful Multifamily Asset and Property Management

HUD and project owners use a wide variety of tools to effectively manage their portfolio and individual properties. These tools not only provide a means of servicing projects, but also for ensuring compliance with HUD programs. Sensible management means using the right tools at the right time. Below is a comprehensive list of the tools available.

### Project Challenges

- High or increasing vacancies.
- Unrentable units and commercial space that is unrentable or rented at uneconomic rates.
- Section 8 units that do not meet HQS and for which project funds are not immediately available to correct the deficiencies.
- Patching jobs, incomplete repairs.
- Lack of curb appeal.
- Significant tenant and/or community complaints.
- Lack of amenities.
- Below satisfactory ratings on reviews.
- Unauthorized distributions.
- Annual or monthly expenses exceeding income.

· Significant change in project expenses.

· Project rents below market because of failure to request increases.

· Reserve for replacement funds requested for expenses for which the account was never intended.

· Annual Financial Statements disclosing significant irregularities qualified auditor's opinions negative cash throw-offs line items that are inconsistent with each other, with prior years, or with similar projected underfunded reserve or escrow accounts increasing accounts payable, receivable, or bad debts.

· Trends, i.e., collections, vacancies, payables, physical deterioration, increasing competition, increasing unemployment.

· Unresponsive owner/agent.

· Police/media reports.

· Code enforcement action.

Once the symptoms of trouble have been identified, it is possible to move on to the next crucial step.

### Determine the Cause

The next step is to determine the causes(s) for the trouble in the projects. The following are major causes for the trouble seen in the projects.

- High interest rates
- Fraud
- Poor owner
- Poor management
- Physical design and environment
- Underwriting problems
- Market (including pricing)

It is most important to determine the cause of the problems of a project and not to simply identify the symptoms or indicators.

For example, a high vacancy rate is a symptom. The cause could be a soft market or poor management. *It is not possible to cure a troubled project without addressing the real cause of the problem.* It is important to avoid trying to treat symptoms rather than causes.



Focus group participants discuss models.

Thorough research and persistence in determining the cause of the trouble helps prevent the frustration of trying ineffective solutions that don't address the real cause of the problem.

## Taking Action

### Management Actions

There are many actions that can be taken to prevent default and aid long term stability of a project.

- Meetings with the HUD owner of a troubled project to negotiate the actions to cure the problem(s).
- Short-term financial actions include owner contributions and releases from reserves.
- Long-term financial actions include rent increases, transfer of physical assets, loans and secondary financing.

- Management actions include:
  - A change in the management agent
  - Training or replacement of project staff
  - Improvement of management practices
  - Closer review of management actions
- Mortgagor continues with the following responsibilities:
  - Maintenance
  - The financial health of the project
  - Keeping the mortgage current

A team approach with the owner should be followed to develop a written plan, with a goal, measurable objectives, actions to be taken, and milestones for each troubled project.

A goal is a generalized end result to be achieved by the plan. Once the goal is determined, a plan needs to be developed with dual objectives, those to be achieved by the owner as well as those for the project manager.

Where appropriate, tenant comment and participation should be invited in developing corrective actions.

Objectives are short-term measurable ends that support the goal. Objectives begin with the word “to” and an action verb and must include a time limit.

### Tenant Relations

Tenants should be given the opportunity to comment on routine project management issues (such as, rent increase processing, management reviews and physical inspections), the development of corrective action plans (receiving input on the condition of the property), disposition of properties (exploring opportunities for conversion to homeownership for purchase by the tenants) and special initiatives or programs (such as Neighborhood Networks).

Actions on the part of owners and management agents that accomplish the following:

- Foster enhanced communication between residents and both on-site and central office management.
- Increase resident access to management.
- Ensure that proper consideration and acknowledgment is given to tenant input.
- Emphasize the importance of promptly resolving problems.

### Focus Group Session Results

On February 17, 2000, the third HUD focus group on best practices was held. This session, on Multifamily Housing, had representation from both the private sector project developers and non-profit housing corporations’ project managers. The model for multifamily property development and management was the focus of discussion. The model or framework for success is included in this issue and HUD welcomes your comments and input on its validity, strengths and weaknesses.

Focus group participants included several 1999 HUD Best Practices winners, HUD staff and Best Practices team members. In attendance were: Bill Harris from Culpepper Gardens, Arlington, VA; Jacqueline Jones, Interstate Realty, Marlton, NJ; Judi Richardson and Billie Tebbens, Henrico Police Apartment Coalition, Richmond, VA; and Robert Tourigny, Hughesville, MD.

Karen Jackson, Associate General Deputy Assistant Secretary for Administration, welcomed participants. She invited all practitioners to share their practical knowledge to help develop HUD’s best practices database.

Reba Cook, Associate Deputy Assistant Secretary for Multifamily Programs, discussed HUD’s change in focus from bricks and mortar to today’s broader mission of health and welfare for low income families. HUD Secretary Andrew Cuomo has emphasized networking to support the multifamily housing mission.

Participants discussed strengths in the multifamily housing development process including the use of technologies such as e-mail and effective project management. On the other hand, weaknesses cited were burdensome paperwork requirements and poor communications.

Following presentation of the draft model, focus group participants identified key factors for successful multifamily housing management. The most important of these were felt to be:

- **Managing change:** Build and nurture partnerships. Practice flexibility in relationships. Keep current on changing HUD program rules.
- **Investing in people:** Maintain well trained supervisory and customer service staff. Empower residents to be actively involved in their communities. Listen to residents.
- **Leadership:** Have a vision for success. Focus on the investments in community that benefit the bottom line.
- **Project oversight:** Maintenance of properties is critical. Enforce rules with fairness. Plan and anticipate needs and budget realistically.

Multifamily housing development had its own, in many cases different, set of success factors. Further discussion highlighted the most important of these as:

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HUD also is using the extensive business experience of public housing agencies and housing finance agencies and other experienced housing organizations to administer many of the project- and tenant-based Section 8 Housing Assistance Payments (HAP). Since the beginning of the year, HUD already has contracted with 15 state-wide housing finance agencies from across the country to oversee HAP contracts, in accordance with HUD regulations and requirements. The contractors will more effectively enforce owner obligations to provide decent housing to residents by adding private sector expertise to a Public Housing Agency's (PHA) administration of the contract. More contractors are still being selected and will be announced as they are awarded.

The contract administrators will work on HUD's behalf with landlords who provide HUD-subsidized apartments in privately-owned buildings. They will perform several tasks including: conducting management and occupancy reviews, adjusting contract rents, processing contract termination or expirations, responding to health and safety issues, following up on results of physical inspections of Section 8 projects, renewing contracts, and submitting Section 8 budgets, requisitions, revisions, and year-end statements.

In addition to preserving affordable housing, HUD is making production of affordable housing easier and faster. HUD has developed a new multifamily accelerated processing system (MAP) that will make processing procedures uniform across the country and eliminate processing delays by delegating greater authority to lenders. MAP will be implemented by this summer.

Last year, HUD helped support the construction or renovation of more than 75,000 units of multifamily housing through FHA. To further increase production, for the first time since 1996 HUD will not limit the construction of new units to only the elderly or disabled, but will get back in the business of producing affordable housing to assist needy families in areas where rental units are in short supply.

To spur the production of housing affordable to the lowest-income Americans in neighborhoods that will provide strong job opportunities and other benefits, HUD's 2001 budget proposes a program that links 10,000 new housing vouchers with the highly successful Low-Income Housing Tax Credit (LIHTC) program and FHA's multifamily insurance programs. These vouchers will be allocated to states along with the LIHTC and will help secure the construction of new units for extremely-low-income renters. Because the vouchers will be limited to no more than 25 percent of the

units in any new development, the program will encourage the construction of at least 40,000 units of mixed-income housing.

The budget proposal requests \$58 million for the 10,000 vouchers, plus \$8 million for one-time incentive payments to developers who build units targeted to under-served groups such as large families.

Finally, FHA will encourage the construction of new retail and other commercial space to complement new housing development through insurance for mixed-use developments.

On the management side, HUD in the last 4 ½ years has supported the Neighborhood Networks initiative, a national community-based initiative that encourages the development of resource and computer learning centers in privately owned HUD-assisted and/or -insured housing. More than 600 Neighborhood Networks of all sizes, scopes, and capacity have been opened since the concept started in September 1996.

Residents of HUD-assisted and/or -insured housing often lack the resources and tools to improve their prospects for self-sufficiency, employability, health care and economic self-reliance. Neighborhood Networks make technology accessible to these residents and in so doing help residents and communities thrive. Local businesses, non-profits, educational institutions, faith-based organizations, civic organizations, foundations, hospitals, community clinics, and federal and state government agencies are joining forces with residents and property owners of HUD-assisted and/or -insured housing to develop and expand Neighborhood Networks centers across the country.

While HUD can set policy, it is really the practitioners who make it work and work well. We are excited about working with Best Practices from across the country this year to find out how they are making programs work to improve peoples' lives. We are eager to hear about ways we can work together to raise the standard for quality affordable housing—and not just the structure, but the community of residents.

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- **Cooperation:** The construction process requires give and take between the lender and construction manager. Smooth flow of information between all parties on the development team is critical. A common set of definitions of terms will help in processing forms.

- **Technology:** Transferring files electronically; using e-mail instead of faxing; and having all practitioners use current technology. Participants applauded Multifamily Accelerated Processing (MAP).

In order to enable success in these areas, practitioners identified and discussed key technical assistance needs. Among those considered most vital are:

- **Training:** Practitioners must know HUD program rules and how to effectively apply them. Computerized training was suggested.

- **Knowledge database:** Participants expressed the need for a clearinghouse for laws, regulations, handbooks, notices, directives, and policy memos. They recommended developing a handbook for resident organizations.

- **Communications:** Participants recommended such tools as electronic alerts for changes in program rules, newsgroups and/or list serves, and town meetings.

### We Want to Hear From You

Please review the multifamily housing model and tell us what you think. As an overall system, what are the strengths in the system? What are the weaknesses? In order to better achieve the goal of providing rental housing, in what areas would you and/or your colleagues like to receive technical assistance? How can HUD improve upon the success factors within the model or the overall success of providing rental housing?

Send your comments and suggestions to Neil Brown, U.S. Department of Housing and Urban Development, 409 Third Street SW., Suite 310, Washington, DC 20024.

### Best Practices Nominations

Submitting a Best Practice has never been easier. Now HUD staff, partners and other outside organizations can submit Best Practice nominations using HUD's internet site. The 2000 Best Practice nominations process opened March 20<sup>th</sup> and runs through May 31<sup>st</sup>. You may access the automated nomination system and obtain other best practices information through our web site at [www.hud.gov/bestpractices.html](http://www.hud.gov/bestpractices.html). We look forward to your nominations.